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FINRA Facts and Trends: June 2022

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Welcome to the latest issue of Bracewell's FINRA Facts and Trends, a monthly newsletter devoted to condensing and digesting recent FINRA developments in the areas of enforcement, regulation and dispute resolution. FINRA's enforcement arm has turned its attention to policing crowdfunding misconduct and trading volume overstatements, while the recent spate of arbitrations over a particular managed options trading strategy continues unabated. Meanwhile, FINRA has followed through on several initiatives involving "restricted firm" designations, complex products and the expungement of complaints against broker-dealers. Read about these issues (and more!) below.

Notable Enforcement Matters and Disciplinary Actions

- **Crowdfunding**. Crowdfunding portals Wefunder Portal, LLC and StartEngine Capital LLC, were fined $1.4 million and $350,000, respectively, for allegedly failing to comply with Regulation CF, the crowdfunding exemption from securities registration. The Letters of Acceptance, Waiver and Consent ("AWC") detailing FINRA's findings are available ***here*** and ***here***.
    - In the Wefunder matter, FINRA found that Wefunder exceeded Regulation CF's crowdfunding limits by approximately $20 million across 39 separate offerings spanning six years. According to FINRA, Wefunder also: failed to promptly direct the transmission of funds to issuers and investors; improperly solicited investments via email to hundreds of thousands of potential investors; posted misleading communications on its funding portal website; and failed to reasonably supervise its employees.
    - In the StartEngine matter, the portal knowingly included allegedly false or misleading issuer communications on its funding portal website. This content included a video for an issuer selling a home robot that massively exaggerated the robot's functionality, and misleading communications from a newly created professional basketball team that never ended up playing a single game.
- **Alternative Funds**. Geneos Wealth Management, Inc., a full-service broker-dealer, was fined $150,000 and was ordered to pay $250,710 in restitution based on allegations that it failed to supervise its registered representatives' recommendations of the LJM

Preservation & Growth Fund (LJM). LJM was an alternative mutual fund that pursued a risky strategy relying, in part, on purchasing uncovered options. The AWC detailing FINRA's findings is available ***here***.

- FINRA found that Geneos had no process in place to determine whether new mutual funds like LJM constituted complex products or alternative mutual funds—which would trigger heightened due diligence procedures—and instead applied traditional mutual fund standards to all new funds. Similarly, according to FINRA, Geneos failed to adopt written supervisory procedures regarding its brokers' recommendations of alternative mutual funds and utilized an electronic trade review system that failed to account for risk factors associated with such funds.

  As a result of these alleged failures, FINRA found that Geneos permitted the sale of more than $2.5 million in LJM on its platform without ensuring that the firm and its representatives had a sufficient understanding of the fund's risks and features.

- **Trading Volume**. FINRA is again turning its attention to policing instances where broker-dealers have overstated their advertised trading volume in violation of FINRA Rules 5210 and 2010. A recent "sweep" of broker-dealers by FINRA's Market Regulation Department has resulted in firm censures and fines against three brokerage firms resulting from inaccurate advertised trading volumes that these member firms reported through third-party service providers. In each instance, FINRA also found that these same broker-dealers lacked adequate supervisory systems and procedures for communicating trade volume to such services. The AWCs detailing FINRA's findings are respectively available ***here***, ***here*** and ***here***.

  - In the case of Wolf Research Securities, an AWC was entered into in which the firm agreed to a censure and was fined $100,000 after a finding that the firm overstated its advertised trading volume on a private subscription-based provider of market data for the period between September 2017 and October 2020. The cause of these overstatements was attributed to a flaw in the advertised logic of its third-party order management system. As a result of this flaw, which persisted for more than a three-year period, Wolf Research overstated its advertised trading volume on 32 occasions and by 90,446,177 shares.

  - In the BIDS Trading L.P. matter, an AWC was entered into in which the firm agreed to a censure and a fine of $200,000 after a finding that the firm overstated its advertised trading volume on a private subscription-based provider of market data for the period from July 2018 to August 2019. BIDS overstated its executed trade volume in 2,041 instances by 439,768,869 shares in 1,043 securities.

  - In the last matter, an AWC was entered into which the firm agreed to a censure and a fine of $1,250,000 after a finding that certain registered representatives

intentionally overstated their advertised trading volume. The inflated volumes were reported to certain media sources that published trade rankings, making it appear that the brokerage firm traded more stock than it actually did in the period from April 2013 through June 2015.

Specifically, FINRA found that the firm's investment banking department maintained a document titled "Focus List," which was subsequently provided to the firm's equity traders. The Focus List contained the names of companies that were either current or prospective investment banking clients and a "target" trade ranking range. The objective was to capture the attention of actual or prospective investment banking clients who might be more inclined to engage a firm that actively traded in its stock. FINRA found that the firm overstated its advertised trading volume in these "Focus List" stocks 962 times, totaling more than 12 million shares.

- **Overcharges**. Merrill Lynch was ordered to repay more than $15 million arising from allegations that it overcharged thousands of brokerage customers who purchased Class C mutual fund shares when Class A shares could have been purchased at a markedly lower cost. The AWC, issued on May 23, 2022, is available ***here***.

    - In its findings, FINRA explained that mutual funds are often offered in different classes of shares, with Class A shares typically having a front-end sales charge, while Class C shares usually carry no upfront charges, but do have higher fees and are often subject to contingent deferred sales charges that are higher than those for Class A shares. While Merrill Lynch did maintain an automated system designed to guard against Class C purchases when Class A shares could be purchased at a discount, there were instances where its system mistakenly applied a purchase limit on Class C shares. As a result, FINRA found that for the period from January 2015 to January 2021, "thousands of Merrill Lynch customers purchased Class C shares, incurring fees and charges, when Class A shares were available at a substantially lower cost," in violation of FINRA Rules 3110 and 2010.

    - In a June 2, 2022 press release announcing its findings, Jessica Hopper, FINRA's Executive Vice President and Head of FINRA's Department of Enforcement, cautioned that firms "must have supervisory systems reasonably designed to ensure that customers are aware of, and receive, available discounts when purchasing mutual funds, and are not charged unnecessary fees and expenses."

    - In electing not to issue a separate monetary fine in addition to the restitution amount, FINRA recognized Merrill Lynch's "extraordinary cooperation" with the investigation, which included engaging an outside consultant to identify the affected customers and developing an effective remediation plan.

FINRA Regulatory Notices

- ***Regulatory Notice 22-12*** – FINRA announced the adoption of amendments to FINRA Rule 6730, which governs Transaction Reporting. Under the amendments, FINRA members are required to append a new "portfolio trade modifier" to FINRA's Trade Reporting and Compliance Engine (TRACE) when reporting certain transactions. Specifically, the new portfolio trade modifier is required in connection with reporting a transaction in a corporate bond that is: (1) executed between only two parties; (2) involving a basket of corporate bonds of at least 10 unique issues; and (3) for a single agreed price for the entire basket. The full Regulatory Notice includes responses to frequently asked questions intended to provide guidance as to the application of the new portfolio trade modifier requirement.

Notable FINRA Arbitration Awards

- We reported last month on a series of customer arbitration proceedings related to investments in a firm's Yield Enhancement Strategy ("YES"), a managed options trading strategy. These cases have continued to be the subject of arbitration proceedings over the past several weeks, and the outcomes have remained mixed, ranging from large monetary awards to complete dismissals.

    - ***20-01732*** – Following a five-day hearing related to a claim brought by Fortezza Investments, L.P., concerning investments in YES, an arbitration panel dismissed the claims against in their entirety, and recommended expungement of the matter from the CRD records of two registered representatives. In recommending expungement, the panel made specific findings that the YES investment was suitable for the Claimant, an experienced investor, and that the Claimant had signed documents indicating that it understood the risks involved in the YES investment.

    - ***20-01960*** – In an arbitration proceeding brought by a family trust customer, a three-arbitrator panel entered an award of approximately $1.1 million against the brokerage firm on claims of misrepresentation and suitability related to a YES investment. The panel further found the firm liable for $26,000 in expert witness fees and $300,000 in attorneys' fees pursuant to New Mexico statutory law.

    - ***20-03856*** – After conducting an arbitration hearing held in fifteen sessions over eight days, a panel awarded two individual Claimants nearly $3 million, plus an additional $1 million in attorneys' fees, on their claim that the YES investment recommended by the firm was unsuitable and inappropriate for Claimants' risk tolerances and investment objectives.

Practice Tip: These mixed results continue to suggest that investment advisors should be cautious in recommending options trading. Firms should implement rigorous controls and regular supervisory reviews with respect to such investment strategy recommendations to ensure the strategies are suitable and that investors are fully informed of the related risks.

- Broker-dealers were found liable in two cases involving failures to execute trades in a timely fashion for their customers, resulting in either losses or lost profits.

    - ***20-03312*** – A three-arbitrator panel in Texas found that a large financial institution and one of its registered representatives were jointly and severally liable for approximately $160,000 in compensatory damages, plus an additional $50,000 in attorneys' fees. The customer had alleged that he had requested a sale of his expiring options, but that a firm employee failed to liquidate the option position in a timely fashion, resulting in losses.

    - ***21-01181*** – A Florida-based arbitration panel similarly found Charles Schwab & Co. liable to one of its customers for approximately $215,000, based on the customer's allegations that Schwab failed to timely place the customer's trade requests, thereby preventing the customer from entering orders to sell his entire stock position in GameStop Corporation. The failure to execute these trades apparently caused the customer to lose an opportunity to capitalize on the recent, well-publicized market craze that caused GameStop stock to soar.

Practice Tip: Firms should review their risk management system and controls and take steps to ensure they provide proper administrative support and resources, in order to timely log and execute all customer trades.

- At least two arbitration panels fully denied large, multi-million dollar claims against broker-dealers following arbitration hearings.

    - ***19-02750*** – In an arbitration proceeding brought against Next Financial Group, Inc., the Claimant, GMS Mine Repair and Maintenance, Inc., sought more than $22 million in damages on allegations that Next Financial recommended to Claimant an investment in a mining operation that was part of a Ponzi scheme. Following a four-day hearing, these claims were denied in their entirety.

    - ***19-03605*** – A group of Claimants brought an arbitration proceeding against several broker-dealers and registered representatives, alleging breaches of contract and other causes of action sounding in fraud, with respect to purchases of various life insurance policies that allegedly led to nearly $2.8 million in damages. The claims were dismissed in their entirety following a ten-day hearing. In a rare step, however, one arbitrator out of the panel of three issued a dissent, explaining that he would have found the Respondents jointly and severally liable for nearly $3 million in damages.

Other FINRA News and Notable Trends

- **Firms Begin Terminating Employees to Avoid "Restricted Firm" Designation**

    - The process of terminating registered representatives with a history of misconduct has begun, as firms proactively seek to avoid the "Restricted Firm" label that FINRA

will begin to hand out in mid-July 2022.

On September 28, 2021, FINRA adopted Rule 4111, which grants FINRA the power to impose new obligations on broker-dealers that historically have higher levels of risk-related disclosures based on certain criteria. Rule 4111 provides for a multi-step process by which FINRA will determine whether a particular firm raises investor protection concerns that are serious enough to warrant the designation of "Restricted Firm." Once a firm is designated as restricted, it can either accept the designation or seek to challenge all or part of FINRA's determination through what essentially amounts to an appeal process. For those firms that choose to accept the designation, they will be required to put aside reserve funds in a "Restricted Deposit Account" that will be used to pay for both future and unpaid investor claims. These funds, which must reside in a separate account, can only be used with the approval of FINRA, and the precise deposit amount will vary for each restricted firm based on the firm's size, financial health and operations.

On June 1st, FINRA began issuing predictive reports to broker-dealers that were in danger of being placed on FINRA's "restricted firm" watchlist. Even before these predictive reports were generated, broker-dealers at risk of being placed on these lists had already begun terminating brokers with a history of misconduct.

For its part, FINRA is reminding its member firms to closely monitor the determination process. Lance Burkett, Senior Director in FINRA's Risk Monitoring department, recommends that firms "[b]e proactive" and to "add or amend disclosures" as necessary. FINRA and Mr. Burkett are aware that some firms have begun to terminate brokers who fall into a high risk category – and the expectation is that other firms will follow suit.

- **The Dialogue on "Complex Products" Begins to Heat Up ???????**
    - The comment period for FINRA Regulatory Notice 22-08, which seeks to address concerns arising from the ease with which retail customers can trade in complex products, expired on May 9th. Thousands of comments have poured in to FINRA, with a clear divide evident between industry commenters, who are concerned about the potential for regulator overreach, and investor advocates, who believe the current proposals do not go far enough in seeking to protect the investing public.

      On the last day of the comment period, the Securities Industry and Financial Markets Association (SIFMA) submitted a 15-page letter to FINRA that highlighted certain concerns. Among the issues raised by SIFMA was that any new guidance about complex products must begin with a narrower definition of that term, which SIFMA contends currently is "too vague and overinclusive."

On May 16th, day one of FINRA's Annual Conference, FINRA CEO Robert Cook and SEC Chair Gary Gensler discussed the "Complex Products" rules, and Chair Gensler appeared to recognize that a balance must be struck between an investor's right to choose what investment risks they are willing to take and an obligation on the part of broker-dealers to recommend trades that are risk-appropriate for the particular investor.

For now, FINRA appears to be preaching patience, with Mr. Cook explaining that "[o]ur minds are not made up about this." FINRA is currently reviewing the comments they have received and then will explore whether "any further action" is appropriate—and what that would look like.

- **FINRA Releases Discussion Paper on Expungement**

  - Last month, FINRA released a Discussion Paper that revisited proposed changes to the process and procedures for brokers seeking the expungement of customer complaints. After earlier proposed rule changes were scratched following claims from the Public Investors Advocate Bar Association (PIABA) that they were too lenient, FINRA seems committed to reviving this discussion. FINRA's "Special Roster Proposal" would call for material changes to the expungement process, including newly-imposed time restrictions for seeking the expungement of aged customer complaints, as well as the creation of a new roster of arbitrators that would be assigned by FINRA to hear most expungement requests.

    With PIABA intent on making the expungement process more onerous, all broker-dealers and their registered representatives should be aware of these developments, especially those seeking to expunge meritless customer complaints currently listed on their permanent CRD record and FINRA's BrokerCheck. The entirety of FINRA's Discussion Paper can be found ***here*.**